TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, 1938

No. ~~838~~ 26

F. H. E. OIL COMPANY, PETITIONER,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR CERTIORARI FILED APRIL 4, 1939.

CERTIORARI GRANTED MAY 1, 1939.

SUPREME COURT OF THE UNITED STATES

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F. H. E. OIL COMPANY, PETITIONER,

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COMMISSIONER OF INTERNAL REVENUE

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—1729

[fols. a-1] [Caption omitted]

[fol. 2]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 78676

F. H. E. OIL COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Appearances:

For Taxpayer: Harry C. Weeks, Esq.
For Comm'r: Byron M. Coon, Esq., W. G. Cullen, Esq.

DOCKET ENTRIES

1935.

Mar. 4. Petition received and filed. Taxpayer notified. (Fee paid).
Mar. 5. Copy of petition served on General Counsel.
Mar. 19. Answer filed by General Counsel.
Mar. 19. Copy of answer served on taxpayer.
Mar. 28. Motion for circuit hearing at Fort Worth, Texas, filed by taxpayer. 3/29/35 Granted to Circuit Calendar.

1936.

Mar. 6. Hearing set week of April 27, 1936, Dallas, Texas.

[fol. 3]

Apr. 6. Motion for leave to file amendment to petition, amendment to petition lodged, filed by taxpayer. 4/6/35 Granted.
Apr. 29. Called April 27, 1936. Hearing had before Mr. Leech on merits. On motion of petitioner to amend petition, granted. Motion to amend petition filed. Copy served. Answer to amended petition to be filed on or before 7/30/36. Stipulation as to facts filed. Petitioner's brief due June 15, 1936. Respondent's brief due July 15, 1936. Reply brief July 30, 1936.

Docket Entries—Continued

May 20. Transcript of hearing of April 29, 1936, filed.
June 15. Brief filed by taxpayer. 6/15/36 copy served on General Counsel.
June 16. Stipulation to correct transcript of record filed. Corrections attached.
July 15. Reply brief filed by General Counsel.
July 30. Answer to amendment to petition filed by General Counsel.
July 30. Copy of answer to amendment to petition served on General Counsel.
Aug. 28. Motion for leave to file reply brief, reply brief lodged. Filed by taxpayer. 9/8/36 Granted.
Sept. 10. Copy of motion and reply brief served on General Counsel.

1937.

Aug. 3. Memorandum Opinion rendered, J. Russell Leech, Div. 6. Judgment will be entered under Rule 50.

[fol. 4]

Oct. 22. Notice of settlement filed by General Counsel.
Oct. 25. Hearing set Nov. 17, 1937 on settlement.
Nov. 15. Consent to settlement filed by taxpayer.
Nov. 22. Decision entered, Jr. Russell Leech, Div. 6.

1938.

Feb. 12 Petition for review by United States Circuit Court of Appeals, Fifth Circuit, with assignments of error filed by General Counsel.
Feb. 24. Proof of service filed by General Counsel. (2) (Taxpayer and Attorney).
Apr. 11. Praecipe filed by General Counsel.
Apr. 12. Proof of service of praecipe filed.
Apr. 15. Certified copy of order from United States Circuit Court of Appeals, Fifth Circuit, enlarging time to April 30, 1938 to transmit and complete the record, entered.
Apr. 30. Order extending time to May 14, 1938, for transmission and delivery of record, entered.

[fol. 5] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket No. 78676

F. H. E. OIL COMPANY, Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE, Respondent

PETITION—Filed March 4, 1935

The above named Petitioner hereby petitions for a redetermination of the deficiency set forth by the Commissioner of Internal Revenue in his notice of deficiency (Bureau Symbols IT:AR:E-4-AAT-90D), dated December 13, 1934, and as a basis of its proceeding alleges as follows.

I

The Petitioner is a Texas corporation with its principal office at 1118 Fair Building, Fort Worth, Texas.

II

The notice of deficiency, a copy of which is attached and marked Exhibit "A", was mailed to the Petitioner on December 13, 1934.

III

The taxes in controversy are income taxes for the fiscal year ended January 31, 1932, and for $8,419.05, all of which is in controversy.

[fol. 6] IV

The determination of tax set forth in the said notice of deficiency is based upon the following errors:

(a) In holding and determining that the Petitioner did not sustain a net loss in the fiscal year ended January 31, 1930, in at least the sum of $17,865.99, and in refusing to reduce the taxable income for the fiscal year here involved by that sum.

(b) In holding and determining that the net loss sustained by Petitioner in the fiscal year ended January 31, 1931, was only $1348.02, and in not determining that said net loss, deductible in determining taxable income for the period here involved, was not at least $15,473.02.

(c) In refusing to allow as a deduction, in determining net income and net loss for the fiscal years ended January 31, 1930, and January 31, 1931, the full amount of salaries actually paid its officers during these respective periods.

(d) In refusing to allow as a deduction from income, for the fiscal year ended January 31, 1932, the sum paid Wm. Fleming as compensation for financial assistance rendered the Company during that period.

(e) In refusing to allow, for the fiscal year ended January 31, 1932, salaries actually paid its executive officers for services rendered during that period.

(f) In including in the Petitioner's income for the fiscal year here involved sums representing a portion of the oil produced and sold from various oil and gas leases operated by Petitioner, which went to the sellers of said oil and gas leases in accordance with the terms of the various purchase contracts by which Petitioner acquired them.

(g) In refusing to allow the Petitioner depletion at the [fol. 7] rate of 27½% upon the sums received in the fiscal year here involved on "oil Payments" derived from leases theretofore assigned by the Petitioner to others.

V

The facts upon which the Petitioner relies as a basis for this proceeding are as follows:

(a) In determining the deficiency here involved the Respondent determined that Petitioner had an adjusted net income of $3634.01 for the fiscal year ended January 31, 1930, and in arriving at said sum, he disallowed as a deduction salaries actually paid to the Petitioner's officers in said fiscal year; the officers and the amounts disallowed being as follows:

Wm. Fleming, President	$13,000.00
F. F. Hardesty, Vice President	5,500.00
R. A. Elliott, Secretary-Treasurer	3,000.00

(b) Excluding from the Respondent's determination of adjusted net income for the fiscal year ended January 31,

1930, the salaries so disallowed as excessive, the Respondent's determination was that the Petitioner sustained a net loss for that period of $17,865.99, he having taken into consideration and adjusted the net income as reported for said period all items which did not enter into and comprise a part of the net loss deductible in computing income for succeeding taxable years.

(c) Respondent further determined that the Petitioner sustained a net loss, for the fiscal year ended January 31, 1931, of $1348.02, which sum was deductible in determining tax liability for the fiscal year ended January 31, 1932. In reaching this determination, the Respondent disallowed the following portion of the salaries actually paid to the officers of the Petitioner hereafter shown for said fiscal year, towit:

[fol. 8] To William Fleming, President	$7,500.00
To F. F. Hardesty, Vice President	5,000.00
To R. A. Elliott, Secretary-Treasurer	1,625.00

(d) But for the disallowance of said salaries, Respondent would have determined and fixed the net loss of Petitioner, for the fiscal year ended January 31, 1931, at $15,473.02, he having taken into consideration in his determination all other items proper to be considered in determining the amount of said net loss to be deducted in computing tax liability for the succeeding year.

(e) In the fiscal year here involved, the Petitioner owned and operated various producing oil and gas leases which it had acquired under arrangements by which one fourth (¼th) of the lessee's share of the oil and gas to be produced from the respective leases was to go to the respective assignors of the Petitioner until they had received fixed sums therefrom; said sums going to them when, as and if the oil was produced, and only out of the oil. Said respective leases and the amounts which the various assignors received in this way from the oil and gas produced therefrom during the fiscal year here involved are as follows:

B. C. Christian Lease	$3,328.11
W. E. Jones Lease	1,470.77
Flemister Lease	4,043.97
Clements Lease	1,100.44
R. Christian Lease	837.20
J. E. Christian Lease	521.38

(f) Petitioner alleges upon information and belief, that no part of the one-fourth of the oil or gas produced during said fiscal year from any of the leases referred to in the preceding sub-paragraph constituted its property or income, and that it did not actually receive said oil and [fol. 9] gas, or the proceeds derived from the sale thereof.

(g) In determining the deficiency here involved, the Respondent included as the Petitioner's income the entire sum of $11,301.87 received by its various assignors, as set forth in sub-paragraph (e) hereof.

(h) Prior to the fiscal year here involved, the Petitioner was the owner of interests in various oil and gas leases in Howard County, Texas, and prior to the fiscal year here involved transferred to The California Company its interest in one of said oil and gas leases known and designated as the "Roberts A Lease", under an arrangement by which the Petitioner received $175,000.00 in cash, and the further sum of $225,000.00 to be paid to it out of one half of 7/8ths of the first crude oil produced, saved and marketed from said lease if, as and when same was produced, saved and marketed, and not otherwise.

Likewise, prior to the fiscal year here involved, the Petitioner transferred to The Moody Corporation its interest in oil and gas leases known and designated as Roberts "B", "D" and "E", under an arrangement by which it received $1,000,000.00 in cash, and the further sum of $1,000,000.00 to be paid out of one fourth (¼th) of 7/8ths of the oil, gas and other minerals to be produced from the said leases; but only as, if and when produced. The cash above referred to and substantial amounts of the "oil payments" from said respective leases were received by Petitioner prior to the fiscal year here involved.

(i) In the fiscal year here involved, the Petitioner received from the said Roberts "A" Lease, to apply upon the said oil payment reserved in the transaction with The California Company heretofore referred to, $10,871.29, and in the same way received from the Roberts "B", [fol. 10] "D" and "E" Leases, involved in the transaction with The Moody Corporation", $28,663.34.

(j) In determining the deficiency here involved, the Respondent failed and refused to allow Petitioner any depletion whatsoever with respect to the said oil payments,

and to the depletion of its said interest in said oil and gas leases.

(k) On or about June 16, 1931, the Petitioner desired financial assistance and to borrow money in order to prosecute actively its business of developing oil properties and producing oil and acquiring additional property, and for that purpose it made an arrangement with its President, Wm. Fleming, in substance, that if the said Wm. Fleming would endorse the notes of said F. H. E. Oil Company in a sum not to exceed $75,000.00, or would advance, in lieu of said endorsement, to the F. H. E. Oil Company such funds, the Company would pay him, either for such endorsement or for such advance, in addition to interest the sum of $25,000.00.

(l) In accordance with said arrangement, the said Wm. Fleming, during the period here involved, advanced various and substantial sums of money to the Petitioner, the maximum advance at any one time aggregating $77,000.00, all of which was outstanding and unpaid at the close of the fiscal year here involved.

(m) In accordance with said arrangement, the Petitioner paid to the said Wm. Fleming, during the fiscal year here involved, the said sum of $25,000.00 and deducted same as an expense in computing tax liability. The Respondent has disallowed all of said sum.

(n) The salaries actually paid to the Petitioner's executive officers, during the fiscal year here in question, were fixed by a resolution of its Board of Directors dated February 14, 1931, in the following amounts:

[fol. 11] To Wm. Fleming, President $12,000.00
To F. F. Hardesty, Vice President 6,000.00
To R. A. Elliott, Secretary-Treasurer 6,000.00

All of which salaries were actually paid during said year.

(o) Respondent, in the determination here involved, treated said $25,000.00 paid to Wm. Fleming for financial assistance as salary or compensation for personal services and disallowed that portion of same.

(p) Petitioner alleges that each and all of the salaries paid by the Petitioner to its said executive officers, for the fiscal years ended January 31, 1930, January 31, 1931 and

January 31, 1932, respectively, were reasonable and were for services actually rendered the Petitioner in the prosecution of its business, and were not excessive and constituted no more than fair, reasonable and just compensation for the services rendered by said officers and that, if said sum of $25,000.00 paid to Wm. Fleming as heretofore set forth in the fiscal year ended January 31, 1932, is properly to be treated as salary or compensation for services, which Petitioner denies, then the aggregate sum so paid to said Wm. Fleming for said fiscal year was no more than reasonable and just compensation for personal services actually rendered, and for expenses incurred by him in the performance of his duties, for which he was not otherwise reimbursed.

(q) Further to support Petitioner's allegation with respect to the reasonableness of said salaries, the Petitioner alleges the following facts:

1. The Petitioner was incorporated under the laws of Texas in January, 1925, with a paid up capital of $10,000.00 and no more. At no time has any additional capital been paid in to the Petitioner, but its holdings of property and its [fol. 12] dividends, as well as its increases of stock, have come from its earnings.

2. The Petitioner's capital stock was increased out of earnings, on December 23, 1933, to $350,000.00, at which figure it stood until subsequent to January 31, 1932.

3. At all times since its incorporation the entire capital stock of the Petitioner has been owned by its said officers in the following proportions:

Wm. Fleming	65%
F. F. Hardesty	25%
R. A. Elliott	10%

4. Prior to the increase of its capital stock on December 23, 1933, and the payment thereby of a stock dividend of 3500%, the Petitioner paid 1800% in cash dividends as follows:

On January 30, 1930	$80,000.00
On March 24, 1930	50,000.00
On January 15, 1931	30,000.00
On December 30, 1931	10,000.00
On December 28, 1933	20,000.00

5. At the close of the fiscal year here involved, the Petitioner alleges upon information and belief that the properties which it then owned, and which as aforesaid had been derived from an original investment of $10,000.00, after the payment of dividends as heretofore set out, were worth, in excess of the Company's liabilities, at least $1,000,000.00.

6. During the entire history of the Petitioner the said Wm. Fleming has been its President and its active Executive Head, and he has devoted to the affairs of said Company the greater portion of his time and attention, it being [fol. 13] alleged upon information and belief that during the three fiscal years here involved the time devoted by him to the Petitioner's affairs amounted to at least eight hours per day during each and — working day.

In addition thereto, the said Wm. Fleming furnished for use in the Company's affairs a valuable automobile, and paid all of the expense of operating and maintaining said automobile without any reimbursement whatsoever from the Petitioner.

7. The said Wm. Fleming is, and was at all of the time involved, a man of substantial means, and of successful and varied business experiences, capable of earning and commanding a salary as large, or larger, than that paid to him by the Petitioner, including the $25,000.00 paid in the fiscal year here involved as heretofore set forth, and capable of earning, had he devoted his time to his own affairs, much more than the amounts paid him by Petitioner for his services.

8. The said F. F. Hardesty has at all times since the incorporation of the Petitioner devoted his entire time and attention to the affairs of the Petitioner. He was at all such times a practical, experienced and capable oil man, and his duties with the Petitioner had chiefly to do with the actual development and operation of the Petitioner's oil properties, in which, as heretofore shown, the Company was very successful. The said Hardesty was at all times capable of commanding and earning a salary larger than that paid to him by the Petitioner.

9. The said R. A. Elliott, early in the Company's history, devoted only a part of his time to the Company's affairs, but during the years here involved devoted all of his time and attention thereto. He had had previous experience in office

work and in the banking business, and his principal duties [fol. 14] with the Petitioner related to office management and work, and to the supervision and control of Petitioner's Land Department, and similar duties. His services at all times were worth, and would have commanded, a salary at least as large as that paid to him by Petitioner.

10. All of the salaries paid to each and all of the aforesaid officers for all periods were duly authorized by the Petitioner's Board of Directors.

11. At no time was the compensation of the Petitioner's officers fixed with reference to their stock holdings, nor was it intended by the Petitioner to do more than to reasonably compensate them for services actually rendered.

(r) During all of the time here involved the Petitioner kept its books and made its income tax returns upon a cash receipt and disbursement basis.

Wherefore, the Petitioner prays that this Board may hear the proceeding and hold and determine that the Respondent erred in each and every respect as to which error is assigned in the fourth paragraph hereof, and to further determine that there is no deficiency due by the Petitioner for the fiscal year ended January 31, 1932, and that it receive such other and further relief as it may be entitled to under the facts alleged.

Harry C. Weeks, Staley Building, Wichita Falls, Texas, Counsel for Petitioner.

[fol. 15] *Duly sworn to by Wm. Fleming. Jurat omitted in printing.*

[fol. 16] EXHIBIT "A" TO PETITION

Washington, D. C.,
December 13, 1934.

IT:AR:E-4.
AAT-90D.

F. H. E. Oil Company,
1118 Fair Building,
Fort Worth, Texas.

SIRS:

You are advised that the determination of your income tax liability for the year ended January 31, 1932, discloses a deficiency of $8,419.05 as shown in the statement attached.

In accordance with section 272(a) of the Revenue Act of 1932, as amended by section 501 of the Revenue Act of 1934, notice is hereby given of the deficiency mentioned. Within ninety days (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day) from the date of the mailing of this letter, you may file a petition with the United States Board of Tax Appeals for a redetermination of the deficiency.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Commissioner of Internal Revenue, Washington, D. C., for the attention of IT:C:P-7. The signing and filing of this form will expedite the closing of your return by permitting an early assessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates thirty days after filing the form, or on the date assessment is made, whichever is earlier.

Respectfully, Guy T. Helvering, Commissioner, by ——— ———, Deputy Commissioner.

[fol. 17]. STATEMENT

IT:AR:E-4.
AAT-90D.

In re F. H. E. Oil Company, 1118 Fair Building, Fort Worth, Texas

Income Tax Liability

Year	Income Tax Liability	Income Tax Assessed	Deficiency
Fiscal ended January 31, 1932	$8,419.05	None	$8,419.05

The deficiency shown herein is based upon the reports dated December 19, 1933 and April 30, 1934, prepared by Revenue Agent W. H. Shirley, and transmitted to you under dates of January 12, 1934, and May 21, 1934.

Careful consideration has been accorded your protest dated February 12, 1934, in connection with findings of examining officer, and the information submitted at a conference held in the office of the internal revenue agent in charge.

Your contention that depletion on the oil payments is allowable has been denied. As far as has been shown, the interests owned in Roberts A. B. D and E leases were sold and transferred without reservation, and therefore no depletion is allowable.

Salaries have been adjusted to what the Bureau believes represents a fair and reasonable compensation for services rendered.

[fol. 18] January 31, 1932

Net income reported on return		($6,125.56)
Add:		
1. Prior year's losses 1930	$33,815.32	
Prior year's losses 1931	17,719.59	
2. Percentage depletion disallowed	6,695.34	
3. Donations disallowed	327.00	
4. Depreciation decreased	5,915.34	
5. Excessive salaries	25,000.00	
		89,472.59
		$83,347.03

F. H. E. Oil Company:		Statement
Brought forward		$83,347.03
Less:		
6. Adjusted loss on assets sold	$82.35	
7. Drilling costs allowed	3,039.06	
8. Depletion increased	9,245.49	
		12,366.90
Adjusted net income		$70,980.13

Explanation of Changes

1. Prior years' losses have been disallowed. The adjusted incomes for the prior years are shown as follows:

Year Ended January 31, 1930

Net income reported on return		($33,815.32)
Add:		
1. Nontaxable interest	$8,573.21	
2. Percentage depletion disallowed	7,403.01	
3. Depreciation decreased	39.41	
4. Excessive salaries	21,500.00	
		37,515.66
		$3,700.34
Less:		
5. Additional cost depletion allowed		66.33
Adjusted net income		$3,634.01

[fol. 19] Year Ended January 31, 1931

Net income reported on return		($17,719.59)
Add:		
1. Life insurance disallowed	$148.74	
2. Percentage depletion disallowed	565.26	
3. Depreciation decreased	1,532.57	
4. Excessive salaries	14,125.00	
		16,371.57
		($1,348.02)

F. H. E. Oil Company:		Statement
Brought forward		($1,348.02)
Less:		
5. Additional cost depletion allowed	$261.84	
6. Adjusted losses on pipe sold allowed	53.93	
		315.77
Adjusted net income		($1,663.79)

2. Percentage depletion has been disallowed, and cost depletion allowed instead.

3. Donations have been disallowed in accordance with article 262, Regulations 74.

4. Additional depreciation has been allowed. See exhibit A.

5. Officers' salaries have been adjusted as follows:

	Claimed	Allowed	Disallowed
January 31, 1930			
William Fleming, president	$25,000.00	$12,000.00	$13,000.00
F. F. Hardesty, vice president	11,500.00	6,000.00	5,500.00
R. A. Elliott, secretary-treasurer	6,625.00	5,000.00	1,625.00
	$37,125.00	$23,000.00	$14,125.00
[fol. 20] January 31, 1932			
William Fleming, president	$37,000.00	$12,000.00	$25,000.00
F. F. Hardesty, vice president	6,000.00	6,000.00	0.00
R. A. Elliott, secretary-treasurer	4,312.50	4,312.50	0.00
	$47,312.50	$22,312.50	$25,000.00

6. Loss on assets sold and junked has been increased $82.25.

7. Additional drilling expenses of $3,039.06 have been allowed.

8. Depletion has been allowed as shown in exhibits B & C.

Computation of Tax

Adjusted net income	$70,980.13
Less:	
Net loss January 31, 1931	1,663.79
	$69,316.34
Tax at 1931 rates:	
12% of $69,316.34 for 11 months	$7,624.80
Tax at 1932 rates:	
13¾% of $69,316.34 for 1 month	794.25
Income tax liability	$8,418.05
Income tax previously assessed	None
Additional tax to be assessed	$8,419.05

A copy of this letter, together with a copy of the statement has been mailed to your representative, Mr. Harry C. Weeks, Commerce Building, Wichita Falls, Texas, in accordance with the authority conferred upon him in the power of attorney executed by you and on file with the Bureau.

[fol. 21]

EXHIBIT "A" TO STATEMENT

IT:AR:E-4
AAT
F. H. E. Oil Company

Depreciation Summary

	Balance in Account—Close of Taxable Year					Depreciation Allowed		
	Year ended January 31, 1929	Year ended January 31, 1930	Year ended Jan. 31, 1931 *1931*	Year ended Jan. 31, 1932	Reserve for Depreciation	Year ended January 31, 1930	Year ended January 31, 1931	Year ended January 31, 1932
Maddox Lease	$349.16	$349.16	$349.16	$349.16	$137.35	$38.97	$38.97	$38.97
Salmon Lease	1,872.07	1,872.07	1,872.07	1,872.07	736.32	195.75	195.75	195.75
Howard Lease-A	1,609.26	1,609.26	1,609.26	1,609.26	632.97	171.25	171.25	171.25
Howard B. Lease	5,580.30	5,580.30	5,580.30	5,580.30	2,094.98	581.16	581.16	581.16
Howard C. Lease	3,492.14	3,492.14	3,492.14	3,492.14	873.03	361.59	361.59	361.59
Howard D. Lease	1,046.99	1,046.99	1,046.99	1,046.99	261.75	110.20	110.20	110.20
Robert C. Lease	3,296.95	3,209.15	4,653.38	4,625.28	488.58	337.60	410.76	483.88
Box Lease		39,687.68	42,074.98	38,066.52		2,281.20	4,711.62	4,361.03
Water Well Equipment								
Box Lease		3,423.16	3,839.08	3,839.08		193.49	407.78	429.57
Hinton Lease			1,196.82	1,196.82			59.84	119.69
Sprinkle Lease			1,261.22	305.10			63.06	30.52
Finch Lease			1,552.05	2,937.90				280.13
Cox Lease			526.08	271.13				27.11
Howard, A. B. C. Lease			839.02	895.04				86.70
Meek Lease			412.80	324.11				32.42
Natzer			851.48					
Roberts Lease Warehouse		613.43	613.43	613.43		30.67	61.34	61.34
Clements Lease				1,659.45				46.31
W. E. Jones Lease				6,157.80				205.73
Duke-Jones Lease				3,544.20				
J. M. L. Christian Lease				611.90				
J. E. Christian Lease				3,062.13				53.84
Mathis Christian Lease				3,465.61				60.43
Randle Christian Lease				9,783.45				87.47

B. C. Christian Lease				16,829.34				450.32
Thompson A. Lease				6,840.92				362.43
Thompson B. Lease				2,025.47				105.12
Thompson C. Lease				1,969.59				103.35
King Lease				996.65				34.01
Flemister Lease				14,248.95				499.17
Potts Lease				217.55				16.69
D. H. Jones Lease				40.99				
Miscellaneous Equipment				2,649.85				39.20
Equipment in Storage		3,774.88	1,652.74	2,290.01				
Drilling Equipment	65,226.34	90,480.19	57,043.67	56,479.21	33,406.97	19,292.19	17,074.43	14,119.80
Furniture and Fixtures	351.67	392.76	1,074.64	1,423.20	88.37	37.21	71.36	124.89
Autos and Trucks	2,368.06	5,003.19	4,844.93	5,774.68	70.55	407.75	672.93	713.33
	$85,192.95	$166,534.36	$138,386.24	$207,086.25	$38,790.87	$24,039.03	$24,992.04	$24,393.40
Debits to the Reserve						6,906.15	33,770.42	1,692.32
Amended Reserve					$38,790.87	$55,923.75	$47,145.37	$69,846.45
Total Depreciation claimed						$24,078.47	$26,524.61	$30,308.74
Total Depreciation allowed						24,039.03	24,992.04	24,393.40
(Decrease)						($19.44)	($1,532.57)	($5,915.34)

(Here follows one paster, folio 22)

[fol. 22]

EXHIBIT "B" TO STATEMENT

IT:AR:E-4
AAT
In re: F. H. E. Oil Company

Depletion—1932

Lease	Production Expenses	Development Expenses	Depreciation on Equipment	Taxes	Percentage of Overhead	Prorata Overhead	Total Expenses	Oil Income	Net Income	Depletion at 27½%	Depletion at Cost	Allowable Depletion
J. E. Christian	$118.30	$1,447.35	$53.84	$60.73	1.91%	$371.00	$2,051.22	$2,085.52	$34.39	$573.52	$26.95	$26.95
M. Christian	107.94	1,025.56	60.43	77.16	2.50%	485.60	1,576.69	2,769.96	1013.27	761.74	122.26 (a)	506.63
R. Christian	119.00	2,297.27	87.47	91.05	3.01%	538.66	3,179.45	3,348.79	169.34	920.92	23.20 (a)	84.67
B. C. Christian	780.52	6,521.23	450.32	347.65	14.64%	2,843.66	10,943.38	13,430.80	2487.42	3693.47	154.01 (a)	1243.71
Clements	380.72	1,302.97	46.31	104.62	4.30%	835.23	2,669.85	4,401.82	1731.97	1210.50	191.82 (a)	865.98
Flemister	797.69	4,501.43	499.17	406.22	18.53%	3,599.26	9,803.77	17,186.06	7382.29	4726.17	760.21 (a)	3691.15
W. E. Jones	134.25	2,147.30	205.73	151.58	6.00%	1,165.44	3,804.30	5,874.18	2069.88	1615.40	106.25 (a)	1034.94
Thompson A	622.98	3,478.43	362.43	126.50	12.47%	2,422.16	7,012.50	5,528.93	(1483.57)	1520.46	165.36	165.36
Thompson B	193.38	1,010.60	105.12	83.98	4.20%	815.80	2,208.88	2,245.80	36.92	617.60	200.09	200.09
Thompson C	233.70	719.72	103.35	80.06	2.90%	563.29	1,700.12	2,066.14	366.12	568.19	136.32 (a)	183.06
Howard A	15.86		175.25	28.41	.86%	167.05	386.57	522.23	136.16	143.75	26.60 (a)	68.08
Howard B	987.07		581.16	57.46	1.79%	347.69	1,973.37	1,063.13	(910.24)	292.36	341.25	341.25
Howard C	247.87		361.59	46.00	1.32%	256.40	911.86	887.79	(24.07)	244.14	383.90	383.90
Howard D	97.05		110.20	16.66	.52%	101.00	342.91	335.99	11.08	92.40	59.92	59.92
Finch H.	535.06	670.67	140.07	55.87	.67%	130.14	1,531.81	448.67	(1083.12)			
Finch C	733.24	50.00	140.06	157.71	13.06%	2,536.76	3,617.77	8,701.11	5083.34	2392.81		2392.81
Roberts C	17.21		483.88	14.62	.28%	54.37	570.08	156.20	(413.88)	42.96	264.51	264.51
Salman	.37		195.75	1.16	.03%	5.83	203.11	18.24	(184.87)	5.02	103.41	103.41
Maddox	.23	4.80	38.57	.60	.01%	1.94	46.14	10.39	(35.75)	2.88	55.51	55.51
Box	2,256.24		4,790.60	231.43	11.00%	2,136.64	9,414.91	9,419.31	4.40	2590.31	783.38	783.38
Non-Production	30.75	8,853.37										
Royalties								00.00	00.00			
Seattle								81.03	81.03	22.28	42.68	42.68
Eason								559.26	559.26	153.80	103.58	153.80
Dougherty								64.51	64.51	17.74	94.25	94.25
McElvey								89.67	89.67	24.66	333.76	333.76
Laffell								199.16	199.16	54.77	182.34	182.34
Wall								47.10	47.10	12.95	31.25	31.25
Enlow								69.70	69.70	-19.17	117.34	117.34
	$8,409.42	$34,030.70	$8,991.30	$2,139.47	100.00%	$19,423.92	$64,110.69	$81,612.01	$17,501.32	$22,443.34	$4,810.15	$13,410.73
						Depletion deducted on return						4,165.24
						Increase						$9,245.49

(a) Allowable depletion limited to 50% of net income

Total Overhead, Per Original Report	$73,559.79
Less officers' salaries disallowed	25,000.00
Adjusted Overhead	$48,559.79
40% Applicable to Lease Operations	$19,423.92

[fol. 23]

IT:AR:E-4
AAT
F. H. E. Oil Company

EXHIBIT "C" TO STATEMENT

Depletion Based on Cost

Property	Beginning	Capital Added	End of Year	Oil Reserves Added	Oil Reserves Total	Year	Unit	Production	Depletion January 31, 1930	Depletion January 31, 1931
Howard "A"	$167.49		$167.49	$4,000.00	$7,157.58	1930	.0234	$1,456.50	$34.08	
	133.41		133.41		5,701.08	1931		1,318.29		
	102.56		102.56		4,282.79	1932		1,136.82		$30.85
Howard "B"	1,979.26		1,979.26	6,500.00	13,697.31	1930	.1444	2,905.72	419.59	
	1,559.67		1,559.67		10,791.49	1931		2,831.20		408.83
	1,150.84		1,150.84		7,960.29	1932		2,363.25		
Howard "C"	1,833.53		1,833.53	4,000.00	8,238.70	1930	.2225	2,737.36	609.06	
	1,224.47		1,224.47		5,501.34	1931		2,007.58		446.68
	777.79		777.79		3,493.76	1932		1,725.40		
Howard "D"	338.99		338.99		3,874.12	1930	.0875	993.54	86.93	
	252.06		252.06		3,880.58	1931		910.82		79.70
	172.36		172.36		1,969.76	1932		684.82		
Salman "A" and "B"	689.86		689.86	200.00	247.35	1930	2.7890	37.92	105.75	
	584.11		584.11		209.43	1931		20.50		57.17
	526.94		526.94		188.93	1932		37.08		
Maddox	332.25		332.25	90.00	116.58	1930	2.8499	28.40	80.94	
	251.31		251.31		88.18	1931		12.61		35.94
	215.37		215.37		52.24	1932		19.48		
Roberts "C"	1,128.48		1,128.48	800.00	1,626.40	1930	.6940	274.77	190.69	
	937.79		937.79		1,351.23	1931		345.99		240.11
	697.68		697.68		1,111.12	1932		381.14		
Box		$7,804.87	7,804.87		145,000.00	1930	.05382	47,613.99	2,562.58	
	5,242.29		5,242.29		97,386.01	1931		19,210.94		1,033.93
	4,208.36		4,208.36		78,175.07	1932		14,555.55		
Finch "A"			133.33	133.33		1931		11.85		
Christian, B C		4,350.00	4,350.00		962,500.00	1932	.0045	19,306.44		
Finch "C"		133.34	133.34			1932		17,240.40		
Jones, W. E.		2,037.50	2,037.50		262,500.00	1932	.0077	7,950.11		
Thompson "A"		750.00	750.00	20,000.00	74,688.00	1932	.01004	16,470.70		
Thompson "B"		1,519.53	1,519.53	15,000.00	42,344.00	1932	.03588	5,576.75		
Thompson "C"		1,519.53	1,519.53	15,000.00	42,344.00	1932	.03588	3,799.22		
Flemister	11,062.50	381.25	11,443.75		492,188.00	1932	.03916	24,164.34		

AAT
F. H. E. Oil Company

Depletion Based on Cost

Property	Beginning	Capital Added	End of Year	Oil Reserves Added	Oil Reserves Total	Year	Unit	Production	Depletion January 31, 1930	Depletion January 31, 1931
Clements		2,500.00	2,500.00		108,750.00	1932	.02298	5,793.99		
Christian, R		3,000.00	3,000.00		667,187.00	1932	.00449	4,034.71		
Christian, M		6,400.00	6,400.00		176,531.00	1932	.03631	3,367.21		
Christian, J. E.		3,500.00	3,350.00		360,938.00	1932	.00928	2,512.68		
Royalties										
Settles		750.00			1,875.00	1930	.400	35.16	14.06	
[fol. 24]										
Settles		735.84			1,839.84	1931	.400	145.77		58.31
		677.53			1,694.07	1932		106.70		
Eason		789.65			9,754.66	1930	.08095	165.96	13.43	
		776.22			9,588.70	1931		1,638.51		132.64
		643.58			7,950.19	1932		1,279.54		
Daugherty	2,226.42		2,226.42	($5,000.00)	2,421.41	1930	.9194	97.38	89.53	93.79
	2,136.89				2,324.03	1931		102.01		
	2,043.10				2,222.02	1932		102.51		
McKelvey	7,396.61		7,396.61	($7,000.00)	2,245.77	1930	3.2935	458.01	1,508.45	
	5,888.16				1,794.76			139.22		458.52
	5,429.64				1,655.54	1932		101.34		
Leffell	2,000.00			($3,000.00)	7,468.75	1930	.8101	370.23	299.93	
	1,700.68				2,098.52	1931		354.98		287.57
	1,[illegible]2.51				1,744.04	1932		225.08		
Wall	312.50					1930	10%	Gas	31.25	
	281.25					1931				31.25
	250.00					1932				
Enlow	2,500.00			4,000.00	2,250.00	1931	1.1111	88.59		98.43
	2,401.57					1932		105.61		
Flemister Combines with Flemister Lease				Total Allowed					$6,046.27	$3,493.72
Cost depletion per return									5,979.94	3,231.88
Increase									$66.33	$261.84
Amended Reserve (Cost basis)				(January 31, 1929)				$13,177.84	$19,244.11	$22,717.83

[fol. 25] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

ANSWER—Filed March 19, 1935

The Commissioner of Internal Revenue, by his attorney, Robert H. Jackson, Assistant General Counsel for the Bureau of Internal Revenue, for answer to the petition of the above-named taxpayer admits and denies as follows:

I. Admits the allegation contained in paragraph I of the petition.

II. Admits the allegations contained in paragraph II of the petition.

III. Admits the allegations contained in paragraph III of the petition.

IV. (a) to (g), incl. Denies that he erred in his determination of the deficiency as shown by notice of deficiency [fol. 26] dated December 13, 1934; and further, denies that he erred in the manner and form as alleged in subparagraphs (a) to (g), inclusive, of paragraph IV of petition.

V. (a) to (r), incl. Denies each material allegation of fact contained in paragraph V, subparagraphs (a) to (r), and subdivisions 1 to 11 of subparagraph (o) of paragraph V of the petition.

VI. Denies generally each and every allegation contained in the petition not hereinbefore specifically admitted, qualified or denied.

Wherefore, it is prayed that the petitioner's appeal be denied.

Robert H. Jackson, Assistant General Counsel, for the Bureau of Internal Revenue. Of Counsel: John H. Pigg, Walter W. Kerr, Special Attorneys, Bureau of Internal Revenue.

WWK/HRF 3-18-35.

[fol. 27] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

MOTION FOR LEAVE TO AMEND PETITION—Filed April 6, 1936

Now comes the Petitioner above named and respectfully prays for leave to file the attached amendment to its petition filed hereon on March 4, 1935, and in support of said motion says that this amendment is necessary in order to present fully to this Board all of its defenses to the deficiency asserted by the Respondent.

Respectfully submitted, Harry C. Weeks, Staley Building, Wichita Falls, Texas, Counsel for Petitioner.

Granted Apr. 6, 1936.

(Signed) J. Russell Leech, Member U. S. Board of Tax Appeals.

[fol. 28] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

AMENDMENT TO PETITION—Filed April 6, 1936

Now comes the Petitioner above named and hereby files the following amendments to its petition filed herein on March 4, 1935, to wit:

I

By adding to Paragraph numbered IV of said petition the following as a sub-paragraph therein:

"(h) In calculating the depletion allowed to the Petitioner for the fiscal year here involved upon oil properties owned and operated by it."

II

By adding to Paragraph V of said petition the following sub-paragraphs:

"(s) Throughout the fiscal year here involved the Petitioner owned and operated oil and gas leases from which substantial quantities of oil were produced. With respect to [fol. 29] these properties the Respondent has allowed Petitioner depletion to the extent shown in the depletion schedule (Exhibit B) composing a part of the deficiency notice mailed to the Petitioner, which deficiency notice is attached as Exhibit "A" to the original petition filed by the Petitioner herein.

The greater portion of said depletion allowances were calculated under Section 114(b) (3) of the Revenue Act of 1928 and Section 114(b) (3) of the Revenue Act of 1932, which provide, in substance, for an allowance for depletion in the case of oil or gas wells equal to 27½% of the taxpayers' gross income from the property, but not to exceed 50% of its net income therefrom, without taking into consideration depletion.

In determining the amount of said depletion allowance with respect to the various properties shown in said Exhibit, and particularly in determining the net income from the various properties for the purpose of arriving at 50% of the net income from said properties, the Respondent took into consideration as an expense to be considered in limiting the depletion allowance "development expense" and "overhead expense" to the extent shown in said schedule. In this connection, Petitioner says that it had consistently followed the practice of charging to expense and deducting all of the cost of drilling oil and gas wells and equipping them, except that portion of such cost represented by physical property, as, for example, casing placed in the wells, pumping equipment, rods, tubing, etc. The remainder of the [fol. 30] cost of developing said property, ordinarily referred to as "intangible drilling costs" were deducted by the Petitioner as an expense, in accordance with its consistent practice aforementioned.

Petitioner further says that in the year involved it incurred and sustained substantial items of expense, ordinarily classified as "overhead expense", consisting of items like officers' salaries, office rent for its general offices, salaries of employees in its general office and numerous other expenses of a similar character, none of which pertained directly to the operation of the various properties shown in the aforesaid exhibit, as to which depletion was allowed.

Respondent, in determining the depletion allowance here complained of, allocated to the various producing properties shown in said Exhibit a portion of said overhead expense and, in this way, the Respondent arrived at the figures denominated "development expense" and "overhead" heretofore referred to, and by the use of said sums, in determining, with respect to each of the properties, the net income for the purpose of limiting the depletion allowance, the Respondent substantially and materially reduced the depletion allowance, with respect to said properties, to which Petitioner is entitled.

Petitioner alleges, upon information and belief, that this action was erroneous and only the items classified in said schedule as "production expenses", depreciation on equipment and taxes should be taken into consideration in calculating the allowable depletion with respect to said properties."

"(t) The Respondent, in fixing the Petitioner's net in- [fol. 31] come, included as a part thereof various oil payments going to others, as alleged in Paragraph V (e) of the petition herein, and, as there alleged, Petitioner contends that none of said sums should be included as a part of its income subject to taxation.

Petitioner here alleges, in the alternative and in the event it is mistaken as to its contention with respect to said oil payments, that it is entitled to depletion with respect to each and all of said sums, and that in determining the depletion allowable on the R. Christian and J. E. Christian leases heretofore described, the Respondent did not include as a part of the gross income from said leases the aforesaid oil payments which had been included as a part of the Petitioner's gross income; these payments amounting to $827.20 in the case of the R. Christian Lease and $521.38 in the case of the J. R. Christian Lease, and because of this Petitioner alleges, in the alternative as aforesaid, that its allowable depletion was erroneously decreased."

Respectfully submitted, Harry C. Weeks, Staley Building, Wichita Falls, Texas, Counsel for Petitioner.

[fol. 32] [File endorsement omitted]

BEFORE UNITED STATES BOARD OF TAX APPEALS

[Title omitted]

ANSWER TO AMENDMENT TO PETITION—Filed July 30, 1936

The Commissioner of Internal Revenue, by his attorney, Herman Oliphant, General Counsel for the Department of the Treasury, for answer to the amendment to the above-named taxpayer's petition, admits and denies as follows:

Denies the allegations contained a subparagraph IV(h) as set forth in I of the amendment to petition.

Admits the allegations contained in subparagraph V (s) as set forth in II of the amendment to petition.

Admits the second, third and fourth subparagraphs as set forth under II (V(s)) of the amendment to petition, on unnumbered second page.

As to the fifth paragraph as set forth under II (V(s)), unnumbered pages two and three of amendment to peti-
[fol. 33] tion, respondent admits the allegations set forth, except that respondent denies petitioner is entitled to greater depletion than was allowed.

As to the sixth paragraph as set forth under II (V(s)), unnumbered page three of amendment to petition, respondent denies that he acted erroneously as claimed by petitioner.

(t) Respondent admits that he did as alleged in subparagraph (t) on unnumbered page three of amendment to petition, but denies petitioner's contentions as set forth thereunder.

As to the last paragraph set forth on unnumbered page three of amendment to petition, respondent denies to the depletion claimed in the alternative in this subparagraph.

Denies generally and specifically each and every allegation set forth in the amendment to petition not hereinbefore admitted, qualified or denied.

Wherefore, it is prayed that taxpayer's appeal be denied.

(Signed) Herman Oliphant, General Counsel for the Department of the Treasury. Of Counsel: B. M. Coon, Special Attorney, Bureau of Internal Revenue.

BMC/per 7/28/36.

[fol. 34] BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Nos. 78676, 83108

F. H. E. OIL COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

Harry C. Weeks, Esq., for the petitioner.
Byron M. Coon, Esq., and W. C. Cullen, Esq., for the respondent.

MEMORANDUM OPINION—August 3, 1937

LEECH:

These consolidated proceedings seek redetermination of deficiencies of $8,419.05 and $10,841.76 in petitioner's income tax determined by respondent for the fiscal years ended January 31, 1932 and 1933, respectively.

Issue #1. This issue arises upon respondent's determination that salaries paid by petitioner to its three officers in each of the taxable years and deducted in arriving at net income, as representing reasonable and necessary expense were, in fact, excessive and actually constituted, in large measure, a distribution of profits to these individuals as the stockholders of petitioner. The question goes further than that of the salaries paid in the two taxable years involved since respondent has adjusted net income of petitioner for the two preceding years 1930 and 1931 by disallowance of portions of the deductions taken in those years for salaries paid to these three individuals, and has, by this adjustment, eliminated net losses computed for those years which were carried forward and reflected by petitioner in determining net income reported for the years before us. The issue, consequently, is whether the salaries paid by petitioner to its officers during the four years in question were reasonable in amount and constituted proper deductions for those years.

[fol. 35] Petitioner was organized in 1925 with a capital of $10,000. The moving spirit in its organization was one William Fleming, who was a successful business man with considerable experience in oil land leasing and developing. In the organization of petitioner, Fleming associated with

himself, F. F. Hardesty and R. A. Elliott, with both of whom he had formerly had business connections and with whose capabilites he was familiar. These two last named individuals were selected by Fleming because of his judgment that they were peculiarly fitted to serve a company engaged in buying, leasing and developing oil properties.

The stock of petitioner was taken, 65 per cent by Fleming, 25 per cent by Hardesty and 10 per cent by Elliott, and the entire issue of stock of petitioner has at all times since been held by these three parties in these same proportions. Upon organization, petitioner engaged in drilling and developing oil leases. This development was on its own as well as the leases of others. In the latter cases the consideration for such services was, in some instances, cash or payment of a specified amount to be made from the proceeds of oil produced, or a definite interest in the property.

For the first year after its organization neither Fleming nor Elliott drew salaries from petitioner, but Hardesty, who has, at all times, been vice-president and was in active charge of drilling operations, was paid a nominal salary. A year or so later, petitioner began paying nominal salaries to Fleming and Elliott. Petitioner was reasonably successful from the creation of the company, considering the amount of capital invested.

In 1929, there was considerable oil development in West Texas and petitioner transferred its operations to that section. For the purpose of these operations it needed a substantial amount of cash but did not wish to strain its new [fol. 36] banking connections by asking a large amount of credit. Fleming was a man of some means and had available the money needed by petitioner. However, at this particular time, the opportunities open to him for investment of this money were very promising and it was realized that to loan his funds to petitioner he would have to forego opportunity for this individual profit. Under these conditions an agreement was entered into by petitioner, with the full understanding and approval of Hardesty and Elliott, that, if Fleming would advance $75,000 to petitioner for use during the fiscal year 1931, petitioned would pay for this financing, the sum of $25,000 and, if this loan was not repaid until the end of the following fiscal year, it would pay an additional sum of $25,000.

Fleming advanced the $75,000 agreed upon and petitioner began its operations in West Texas, leasing and develop-

ing properties. These operations were very profitable. During the fiscal year 1932 it paid to Fleming the $25,000 agreed upon and, the following year, the amount advanced by Fleming, not being repaid until late in the year, an additional bonus payment of $18,800 was made under the agreement.

In addition to the bonuses paid Fleming in the fiscal years 1932 and 1933, petitioner paid salaries to its three officers for those years and the two preceding years, as follows:

	Fleming	Hardesty	Elliott
1930	$25,000	$11,500	$8,000.00
1931	19,500	11,000	6,625.00
1932	12,000	11,000	6,819.50
1933	25,000	11,000	6,819.50

In adjusting the net income of petitioner for the fiscal years 1930 and 1931 resulting in the elimination of the reported net losses for such years, respondent allowed the [fol. 37] deduction of a salary of $12,000 to Fleming, $6,000 to Hardesty and $5,000 to Elliott. He disallowed, in the case of each, deduction of the balance of the salary payments made. In determining the deficiencies for the fiscal years 1932 and 1933, respondent allowed deductions of salaries paid for each of those years of $6,000 to Hardesty and $4,312.50 to Elliott and disallowed deduction of the balance of the amounts paid these individuals in those years. As to Fleming, the respondent treated as salary payments, the total of salary and bonus for financial assistance paid him in each year. He allowed $12,000 in each year and disallowed the balance. These totals were $37,000 in 1932, and $43,800 in 1933, and in fact represented, in the first year, $12,000 salary and $25,000 bonus, and, in the second year, $25,000 salary and $18,800 bonus.

The facts established by the evidence demonstrate to our satisfaction that Fleming, Hardesty and Elliott were all men of unusual ability and rendered to petitioner services, the value of which is demonstrated by the very large earnings realized during the years in question. Petitioner, organized in 1925 with a capital of $10,000, has had no additional capital contribution, yet on January 30, 1930 it paid a cash dividend of 800 per cent and, during the next fiscal year, 800 per cent. In the fiscal year 1932, it paid 100 per cent and in the succeeding fiscal year, 200 per cent in cash

dividends. On December 29, 1933, it paid a stock dividend of $340,000, or $3,400 per cent, and, in the following year, a stock dividend of $250,000 and a cash dividend of $75,000. At the time of the hearing it appeared that petitioner owned properties worth approximately $3,000,000.

The situation shown here is unusual and justifies the payment of substantial salaries to those officers responsible [fol. 38] for petitioner's tremendous growth. It is quite evident that, to the services rendered by these three individuals, at least to a very great degree, petitioner owes its exceedingly prosperous record.

The decisions cited by respondent are clearly distinguishable on their facts from the present case. Those are cases where the profits of the corporation were exhausted by salary payments, or the services rendered for which such salaries were paid were not disclosed, under the particular circumstances existing, to have justified the payments made. The case of Shwayder Bros., Inc., v. Nicholas, decided by the U. S. District Court of Colorado, April 16, 1936, 17 A. F. T. R. 1086, to which particular attention is directed by the respondent, illustrates the difference between those cases and the one at bar. In the Shwayder case the earnings of the corporation, left after payment of the regularly authorized salaries to officers, who were also stockholders in the company, were paid over to such officers substantially in proportion to their stockholdings and an entry made on the closing day of the taxable year, charging these additional payments as salary, in each instance. The amount involved was in addition to the regular salaries which had been paid for several years to these officers. No additional salary to any officer was shown to be justified by the conditions existing in the taxable year and the payments in question were not authorized by corporate action. Among the payments made, was one of a salary to the wife of a deceased former stockholder who admittedly rendered no service to the corporation and held no office. The payments made, left no funds from which dividend payments could be made.

In the present case it is revealed that the corporation, in the four years here involved, paid cash dividends of 1,900 per cent on its capital stock in addition to large stock divi- [fol. 39] dends. The fact that a net loss for income tax puporses was computed for the fiscal years 1930 and 1931 is of no significance since it is shown that those years were

very prosperous for the company through the acquisition of rights which, although they produced no income in those years, meant an enormous income in later years to the company, upon which it would then pay tax. These rights constituted so-called oil payments from production, and, after the years in question, very large sums have been realized by petitioner from this source.

We find that the salaries paid by petitioner to these three executives for the four years in question were reasonable and necessary and constituted proper deductions for those years. We also find that the bonus duly contracted for and paid Fleming, in the two taxable years before us, was a proper and necessary expense and that the payments made, in each year were proper deductions in arriving at net income. Cf. Wiggin Terminals, Inc., v. United States, 36 Fed. (2d) 893.

With respect to Issues 2 to 5, inclusive, the facts have been formally stipulated and the parties are in full agreement as to all the figures involved. The questions presented are of law, alone. On these issues we find the facts as stipulated. Only such of the facts as are necessary to an understanding of these remaining issues will be set out.

Issue #2. Petitioner, during the fiscal years 1932 and 1933, realized income from certain oil payments or rights to receive stated sums from the proceeds of the sale of oil. One of these payments it acquired as compensation for drilling and development work done by it for the owner of the property on which such work was done. The others constituted rights retained by petitioner on its sale of prop- [fol. 40] erties or assignments of leases owned by it. Respondent has denied petitioner allowances for depletion on this income. In each case, this income consists of the proceeds of oil production paid direct to petitioner by the pipe line companies purchasing the oil and is the proceeds of oil to which petitioner was entitled upon its production. Petitioner's right to this portion of the production constituted, in each case, an economic interest in the property. Thomas v. Perkins, — U. S. — (decided June 2, 1937). See also Commissioner v. Fleming, 82 Fed. (2d) 324; Commissioner v. Elliott Petroleum Co., 82 Fed. (2d) 193; Alexander v. Continental Petroleum Co., 63 Fed. (2d) 927; Commissioner v. Williams, 82 Fed. (2d) 328; Commissioner v. O'Donnell, — Fed. (2d) —, (C. C. A. 9, June 14, 1937);

Elbe Oil Land Development Co., v. Commissioner, — Fed. (2d) —, (C. C. A. 9, June 21, 1937); Chester Addison Jones, 31 B. T. A. 55; affd., 82 Fed. (2d) 329. The petitioner is entitled to the deduction of depletion with respect to this income received. Palmer v. Bender, 287 U. S. 551.

Issue #3. This issue is the converse of issue 2, Respondent, in determining the deficiency, has included in petitioner's income, amounts paid direct by the pipe line companies purchasing oil produced from leases operated by petitioner, to the parties from whom petitioner acquired these properties. All these payments were those to which these parties were entitled under the conveyance to petitioner. The exact question thus presented was decided in Thomas v. Perkins, supra. The rights of these parties represented retained economic interests in the properties and the income in dispute was that of the parties receiving it. Therefore, it is not to be included in a petitioner's gross income.

Issue #4. In arriving at net income from the properties [fol. 41] for the purpose of applying the limitation of 50 per cent for calculation of the 27½ per cent depletion allowance under section 114 (b)(3) of the Revenue Act of 1932,[1] respondent has deducted from gross income "overhead expense" and "intangible drilling costs", which petitioner had charged off in the current year as deductible expenses.

The intangible drilling costs may not be deducted in computing net operating income and we hold respondent was in

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[1] Sec. 114. Basis for Depreciation and Depletion.

• • • • • • • •

(b) Basis for Depletion.—

• • • • • • • •

(3) Percentage Depletion for Oil and Gas Wells.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

error in so doing. Ambassador Petroleum Co. v. Commissioner, 81 Fed. (2d) 474; Mountain Products Corp., 34 B. T. A. 409; Wilshire Oil Company, Inc., 35 B. T. A. 450.

With respect to the "overhead expenses", respondent has made an allocation of the portion of such expense attributable to oil production. Only that part of the overhead [fol. 42] expense so determined by respondent as attributable to production has been deducted by him in determining net operating income. Petitioner does not question the correctness of the allocation. It takes the broad position that no part of overhead expense can constitute an operating cost. With this position we do not agree. Such portion of the overhead expense as is property allocable to the activities of the corporation in production of oil are as much an expense of that production as payrolls of the laborers engaged in the work. The record does not disclose that the allocation made by respondent is incorrect. Accordingly, we sustain his action in the deduction of this portion of the overhead expense. Rocky Mountain Oil Company, 36 B. T. A. —, (promulgated July 23, 1937).

The conclusion reached that intangible drilling costs are not subject to deduction in computing net operating income, makes it unnecessary to pass upon the last issue, which is merely upon the correct method of determining the amount of such costs.

Enter.

Judgment will be entered under Rule 50.

Entered Aug. 3, 1937.

(Seal.)

[fol. 43] BEFORE UNITED STATES BOARD OF TAX APPEALS

Docket Nos. 78676, 83108

F. H. E. OIL COMPANY, Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE, Respondent

DECISION

Pursuant to the Memorandum Opinion of the Board entered August 3, 1937, the respondent herein having filed on October 22, 1937, a notice of settlement and proposed re-

computation, and the petitioner, on November 15, 1937, having acquiesced in the recomputation as made by the respondent, now, therefore, it is

Ordered and Decided: That there are deficiencies in income tax for the fiscal years ended January 31, 1932 and January 31, 1933, in the respective amounts of $76.97 and $1,721.46.

Enter.

(S.) J. Russell Leech, Member.

Entered November 22, 1937.

(Seal.)

[fol. 44] [File endorsement omitted]

IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

PETITION FOR REVIEW AND ASSIGNMENTS OF ERROR—Filed February 12, 1938

To the Honorable Judges of the United States Circuit Court of Appeals for the Fifth Circuit

Now Comes Guy T. Helvering, Commissioner of Internal Revenue, by his attorneys, James W. Morris, Assistant Attorney General, J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue, and Byron M. Coon, Special Attorney, Bureau of Internal Revenue, and respectfully shows:

I

Jurisdiction

The petitioner on review, hereinafter referred to as the Commissioner, is the duly appointed, qualified, and acting [fol. 45] Commissioner of Internal Revenue of the United States, holding his office by virtue of the laws of the United States. The respondent on review, the F. H. E. Oil Company, hereinafter referred to as the taxpayer, is a corporation organized under the laws of the State of Texas, with its

principal office at 1118 Fair Building, Fort Worth, Texas. The said F. H. E. Oil Company filed its income tax return for the fiscal year ended January 31, 1932, with the Collector of Internal Revenue for the Second District of Texas on April 13, 1932, whose office is located at Dallas, Texas, within the judicial circuit of the United States Court of Appeals for the Fifth Circuit.

The Commissioner of Internal Revenue files this petition pursuant to the provisions of Sections 1001, 1002 and 1003 of the Revenue Act of 1926, (44 Stat. 109, 110), as amended by Section 603 of the Revenue Act of 1928, (45 Stat. 791, 873), as further amended by Section 1101 of the Revenue Act of 1932, (47 Stat. 285), as amended by Section 519 of the Revenue Act of 1934, (48 Stat. 760).

II

Prior Proceedings

On December 13, 1934 the Commissioner determined a deficiency in income tax against the taxpayer for the fiscal year ended January 31, 1932 in the amount of $8,419.05 and sent by registered mail a notice of said deficiency in accordance with the provisions of Section 272(a) of the Revenue Act of 1932, (47 Stat. 233), as amended by Section 501 of the Revenue Act of 1934, (48 Stat. 752). Thereafter on March 5, 1935 the taxpayer filed an appeal from the said determination with the United States Board of Tax Appeals contesting the amount of the deficiency determined by the Commissioner as aforesaid. The Commissioner filed his answer [fol. 46] to the said petition on March 19, 1935 denying the allegations of error contained in the petition. On April 6, 1936 the petitioner filed an amendment to the petition which was duly answered by the Commissioner. Issue having been joined the case was tried before the United States Board of Tax Appeals on April 29, 1936 upon an agreed statement of facts supplemented by the oral testimony of witnesses produced by the respective parties at the hearing. On August 3, 1937 the Board rendered its memorandum opinion in the case and on November 22, 1937 entered its decision wherein it was ordered and decided that there was a deficiency for the said fiscal year ended January 31, 1932 of $76.97.

III

Nature of Controversy

Petitioner was organized in 1925 with a capital of $10,000 and immediately thereafter engaged in drilling and developing oil leases, some of which it owned, and some of which belonged to others. As to the leases belonging to others, the consideration in some instances was the payment of a specified amount to be made from the proceeds of oil produced therefrom. In 1929 the marked activity in the oil fields of West Texas, encouraged the petitioner to transfer its operations to that section. It was actually engaged in that locality until and during the fiscal year ended January 31, 1932.

Throughout the fiscal year just mentioned the taxpayer owned and operated oil and gas leases from which substantial quantities of oil were produced and with reference to which the taxpayer was entitled to statutory depletion. The taxpayer followed the practice of charging to expense and deducting from income all intangible drilling costs except that represented by physical properties such as casings, [fol. 47] pumping equipment and the like. In the fiscal year 1932 the taxpayer had such intangible drilling and development costs as above described in the sum of $34,030.70 which it deducted as expense.

In determining the taxpayer's depletion allowance for the fiscal year, in those operations where the taxpayer was entitled to percentage depletion, the respondent treated intangible drilling costs as deductible in arriving at 50 per cent of the net income from the respective properties computed without allowance for depletion for the purpose of arriving at the limitation on percentage depletion provided for in Section 114 (b) (3) of the Revenue Act of 1932, (47 Stat. 169, 202).

Section 114(b)(3) of the Revenue Act of 1932 (47 Stat. 202), reads as follows:

"Percentage depletion for oil and gas wells.—In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the tax-

payer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Article 221(3)(h) of Regulations 77, reads as follows:

"(h) 'Net income of the taxpayer (computed without allowance for depletion) from the property', as used in section 114(b)(2), (3), and (4) and articles 221 to 248, inclusive, means the 'gross income from the property' as defined in [fol. 48] paragraph (g) less the allowable deductions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (g) in so far as they relate to the product of such property, including overhead and operating expenses, development costs properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion. Deductions not directly attributable to particular properties or processes shall be fairly allocated."

IV

Assignments of Error

The petitioner herein, the Commissioner of Internal Revenue, shows that he is aggrieved by the Opinion of the Board of Tax Appeals and injured thereby, and that the errors complained of are as follows:

(1) The Board erred in holding and deciding that in computing the percentage depletion for oil and gas wells under Section 114(b) (3) of the Revenue Act of 1932, (47 Stat. 169, 202), the taxpayer is entitled to have the 50 per cent limitation of its depletion allowance computed upon the net income from the property without reduction by the amounts of intangible drilling expense deducted by it in the taxable year as development costs.

(2) The Board erred in failing to hold and decide that in computing the percentage depletion for oil and gas wells under Section 114(b)(3) of the Revenue Act of 1932, (47 Stat. 169, 202), the taxpayer is not entitled to have the 50 per cent limitation of its depletion allowance computed upon the net income from the property without reduction by the

[fol. 49] amounts of intangible drilling expense deducted by it in the taxable year as development costs.

(3) The Board erred in that its opinion and decision are contrary to law.

Wherefore, the Commissioner petitions that the decision of the Board of Tax Appeals be reviewed by the United States Circuit Court of Appeals for the Fifth Circuit, that a transcript of the record be prepared in accordance with law and with the rules of said Court and transmitted to the clerk of said Court for filing, and that appropriate action be taken to the end that the errors complained of may be reviewed and corrected by said Court.

(Sgd.) James W. Morris, Assistant Attorney General. (Signed) J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue. Of Counsel: B. M. Coon, Special Attorney, Bureau of Internal Revenue.

BMC/lmv 2/7/38.

[fol. 50] *Duly sworn to by Byron M. Coon. Jurat omitted in printing.*

[fol. 51] [File endorsement omitted]

IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

NOTICE OF FILING PETITION FOR REVIEW—Filed February 24, 1938

To Harry C. Weeks, Esquire, 1401 Sinclair Building, Fort Worth, Texas:

You are hereby notified that the Commissioner of Internal Revenue did, on the 12th day of February, 1938, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by the [fol. 52] United States Circuit Court of Appeals for the Fifth Circuit, of the decision of the Board heretofore rendered in the above-entitled case. A copy of the petition

for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 12th day of February, 1938.

(Signed) J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

BMC/lmv 2/7/38.

Personal Service of the above and foregoing notice, together with a copy of the petition for review and assignments of error mentioned therein, is hereby acknowledged this 17 day of February, 1938.

(Sd.) Harry C. Weeks, Attorney for Respondent on Review.

[fol. 53] [File endorsement omitted]

IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

NOTICE OF FILING PETITION FOR REVIEW—Filed February 24, 1938

To F. H. E. Oil Company, 1118 Fair Building, Fort Worth, Texas:

You are hereby notified that the Commissioner of Internal Revenue did, on the 12th day of February, 1938, file with the Clerk of the United States Board of Tax Appeals, at Washington, D. C., a petition for review by [fol. 54] the United States Circuit Court of Appeals for the Fifth Circuit, of the decision of the Board heretofore rendered in the above-entitled case. A copy of the petition for review and the assignments of error as filed is hereto attached and served upon you.

Dated this 12th day of February, 1938.

(Signed) J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

BMC/lmv 2/7/38.

Personal Service of the above and foregoing notice, together with a copy of the petition for review and assign-

ments of error mentioned therein, is hereby acknowledged this 16 day of February, 1938.

(Sd.) F. H. E. Oil Co., by (Sd.) Wm. Fleming, Pres.
(Title), Respondent on Review.

[fol. 55] BEFORE UNITED STATES BOARD OF TAX APPEALS

EXCERPTS FROM STIPULATION OF FACTS FILED AT HEARING APRIL 29, 1936

II

* * * * * * *

(g) Throughout all its entire history the Petitioner followed the practice of capitalizing only so much of the amounts expended by it in drilling oil and gas wells on properties owned by it as was represented by physical equipment installed or used in said drilling and development. Such items consisted, in the main, of casing placed in the well, pumping rods and tubing, other pumping equipment, tanks, derricks and other physical property which had a salvage value, together with costs necessary in the installation of casing and equipment and in the construction of derricks and other physical structures. The remainder of the cost of drilling the said wells, ordinarily referred to as "intangible drilling costs" made up chiefly of expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, was consistently treated by the Petitioner as deductible in arriving at its net income for each taxable year. This practice was consistently followed throughout the fiscal years ended January 31, 1932, and January 31, 1933.

In those cases in which the Petitioner owned jointly with others the property developed, it followed this practice of capitalizing the cost of physical equipment as to its share of the cost. For example, if the Petitioner owned a one half interest in an oil and gas lease, it paid one half of the cost of said physical equipment and capitalized this amount. Further, the Petitioner, in many cases in which it owned jointly with others oil and gas properties, carried on the work of drilling oil wells thereon by contract with the other joint owner—that is to say the Peti-

[fol. 56] tioner would agree to drill a certain oil well at a specified price per foot of depth, it to furnish the necessary drilling equipment and all of the labor used in drilling the well and jointly with its co-owners furnish all casing and other physical equipment, all fuel, water and similar items. In these cases the Petitioner treated the amount it received from its co-owner as its share of the contract drilling price as income from drilling operations, and it treated all costs of labor, repairs, depreciation on drilling equipment, and other costs connected with the carrying out of such contracts as the expense of drilling wells by contract. Such expenses usually, if not always, exceeded the sums received by Petitioner from its co-owners as their share of the contract price, and this excess only was treated by the Petitioner as its share of the intangible drilling costs incurred in developing jointly owned properties. The result of this practice was to reduce, by the apparent profit made on drilling done for co-owners, the amount deducted by Petitioner as intangible drilling costs with respect to said drilling operations.

In determining the Petitioner's depletion allowance for both fiscal years here involved, in these cases in which Petitioner was entitled to percentage depletion, the Respondent treated said intangible drilling costs as deductible in arriving at 50% of the net income from the respective properties computed without allowance for depletion, for the purpose of arriving at the limitation on percentage depletion provided for in Section 114 (b) (3) of the Revenue Act of 1932 (and the corresponding provisions of any other pertinent Act). Likewise, the Respondent treated as a deduction, in arriving at the net income of the respective properties, computed without allowance for depletion for the purpose of fixing said limitation on depletion allowance, a portion of the overhead expense sustained by the [fol. 57] Petitioner in the respective years. This overhead expense was made up chiefly of officers' salaries, salaries of office employees, office rent and other items of general administrative expense, the details of which will be more fully shown by the evidence.

The method employed by the Respondent with respect to this item of overhead expense was to fix a percentage of the total overhead expense, which was attributable to the production of oil, and then to allocate between the respective producing properties the percentage of the total over-

head so fixed as attributable to the business of producing oil. This allocation, as between the various producing properties, was made upon the basis of the amount of oil produced from the respective properties during the taxable year for which the allocation was made. For example, if one property produced 5% of the total number of barrels produced by Petitioner during that year, there was allocated to it 5% of that portion of the total overhead determined by the Respondent to be attributable to the business of producing oil.

In the fiscal year ended January 31, 1933, the Respondent increased the amount of the intangible drilling costs, taken into consideration in determining depletion allowances as above set forth, by the following: "One half of direct charges to drilling operations $17,446.85. One half of indirect charges to drilling operations $26,662.91." This was explained by the Respondent, in a Revenue Agent's Report covering the fiscal year ended January 31, 1933, and approved and adopted by him in determining the deficiency here involved, as follows:

"The allowable depletion is shown in Exhibit L. No depletion is allowed on the receipts from oil payments on leases sold in a prior year. The total cost of these sales [fol. 58] has been deducted in the prior year. Taxpayer has elected to charge to expense intangible drilling costs. The corporation does its own drilling.

The wells drilled in fiscal year 1933 with exception of those on the J. Barnes Lease, were drilled on leases owned jointly with Fleming-Kimbell Corporation. The taxpayer had no interest in the J. Barnes Lease. On its books and in the tax return the actual drilling labor and other costs have been charged against drilling income. This drilling income was received from Fleming-Kimbell Corporation.

It appears that since the corporation in drilling a well on the jointly owned lease, drills for itself as well as Fleming-Kimbell Corporation, one half of the drilling labor and other costs should be considered as development expenses on its own properties, and one-half charged against drilling income.

This will not affect the book profit and loss, but it will affect statutory depletion, since all development expense is chargeable against gross income in arriving at net income for the purpose of computing the allowable depletion. The allocation of overhead and the computation of the correct

development expense on each well is shown in Exhibit J of this report."

* * * * * * * *

(S.) Harry C. Weeks, Attorney for Petitioner. (S.) Herman Oliphant, Attorney for Respondent.

[fol. 59] [File endorsement omitted]

IN UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

[Title omitted]

PRÆCIPE FOR RECORD—Filed April 11, 1938

To the Clerk of the United States Board of Tax Appeals:

You will please prepare, transmit and deliver to the Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, copies duly certified as correct of the following documents and records in the above-entitled cause in connection with the petition for review by the said Circuit Court of Appeals for the Fifth Circuit, heretofore filed by the Commissioner of Internal Revenue:

1. Docket entries of proceedings before the Board.
2. Pleadings before the Board.

(a) Petition, including annexed copy of deficiency letter.
[fol. 60] (b) Answer.

(c) Amendment to petition lodged with the Board on April 6, 1936.

(d) Motion lodged with the Board on April 6, 1936, and granted by the Board on that date.

(e) Answer to amendment to petition filed with Board on July 30, 1936.

3. opinion and decision of the Board.

4. Petition for review, together with proof of service of notice of filing petition for review and of service of a copy of petition for review.

5. So much of the stipulation of facts offered and received in evidence by the Board on April 29, 1936, as is contained in paragraph (g), pages 8, 9, 10 and 11 thereof.

6. Orders enlarging time for the preparation, transmission and delivery of the record not included in record.
7. This praecipe.

(S.) J. P. Wenchel, Chief Counsel, Bureau of Internal Revenue.

Service of a copy of the within praecipe is hereby admitted this 12th day of April, 1938, and agreed to.

Harry C. Weeks, Attorney for Respondent.

JEF/acb 4/11/38.

[fol. 61] Clerk's certificate to foregoing transcript omitted in printing.

[fol. 62] That thereafter the following proceedings were had in said cause in the United States Circuit Court of Appeals for the Fifth Circuit, viz:

ARGUMENT AND SUBMISSION

Extract from the Minutes of February 15, 1939

No. 8800

COMMISSIONER OF INTERNAL REVENUE

versus

F. H. E. OIL COMPANY

On this day this cause was called, and, after argument by Arnold Raum, Esq., Special Assistant to the Attorney General, for petitioner, and Harry C. Weeks, Esq., for respondent, was submitted to the Court.

[fol. 63] OPINION OF THE COURT—Filed March 21, 1939

IN THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

Nos. 8800 and 8801

COMMISSIONER OF INTERNAL REVENUE, Petitioner,

versus

F. H. E. OIL COMPANY, Respondent

Petitions for Review of Decision of the United States Board of Tax Appeals, (District of Texas)

(March 21, 1939)

Before Foster, Hutcheson and McCord, Circuit Judges

FOSTER, Circuit Judge:

These two cases present petitions by the Commissioner of Internal Revenue to reverse decisions by the Board of Tax Appeals. They involve identical questions of fact and law and may be conveniently disposed of by one opinion.

The Commissioner disallowed certain deductions by the taxpayer, F. H. E. Oil Company, in making its returns for 1932 and 1933 and determined deficiencies respectively of $8,419.04 and $10,841.76. The Board reversed the Commissioner and redetermined deficiencies as $76.97 and $1,721.46 for the respective years. The redetermination [fol. 64] by the Board involved a number of separate items. Only those dealing with allowances for depletion are before us for consideration.

The Revenue Act of 1932, which governs, provides as follows:

Sec. 23(1) "Depletion.—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary."

Sec. 23(3) "Percentage Depletion for Oil and Gas Wells. —In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance be less than it would be if computed without reference to this paragraph."

Treasury Regulations 77, promulgated under the 1932 Act, so far as necessary to quote, are as follows:

Art. 221. (h) "Net income of the taxpayer (computed without allowance for depletion) from the property," as used in section 114 (b) (2), (3), and (4) and articles 221 to 248, inclusive, means the "gross income from the property" as defined in paragraph (g) less the allowable deduc- [fol. 65] tions attributable to the mineral property upon which the depletion is claimed and the allowable deductions attributable to the processes listed in paragraph (g) in so far as they relate to the product of such property, including overhead and operating expenses, development costs

properly charged to expense, depreciation, taxes, losses sustained, etc., but excluding any allowance for depletion."

Art. 236. (1) "Option with respect to intangible drilling and development costs in general: All expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil or gas, may, at the option of the taxpayer, be deducted from gross income as an expense or charged to capital account. Such expenditures have for convenience been termed intangible drilling and development costs."

The material facts are not in dispute. The taxpayer, F. H. E. Oil Co. is a Texas corporation, organized in 1925. It has an economic interest in a number of oil wells in the West Texas Oil Field entitling it to take deductions for depletion. Since beginning business respondent has consistently capitalized certain items of intangible drilling and development costs, such as physical property having salvage value, together with the cost of installing it, but has deducted other items so classified as expense, in determining its net income returnable for taxation.

The Commissioner allowed as depletion 27½% of the gross income from each oil well or 50% of the net income, whichever was lower. In determining the amount of net income he included in the items to be deducted from gross income the amount of intangible drilling and development costs deducted on its returns by the taxpayer as expense. [fol. 66] The Board overruled the Commissioner, on the authority of the following decisions. Ambassador Petroleum Co. vs. Commissioner, 81 F. (2d) 474; Mountain Producers Corp., 34 BTA 409; and Wilshire Oil Co., Inc., 35 BTA 450, subsequently affirmed in Commissioner vs. Wilshire Oil Co., Inc., 95 F. (2d) 971.

The decision in Ambassador Petroleum Co. vs. Commissioner, supra, deals with the 1926 Act. It reversed the Board and has been consistently followed by the Board ever since. The Court considered the rule of legislative approval urged by the Commissioner and turned it against him. Based upon the history of the law and Treasury rulings, the Court concluded, for the purpose of computing depletion, net income and operating profit are synonymous and held that development costs deducted as expense should be excluded in computing net income. The case of Com-

missioner vs. Wilshire Oil Co., Inc., supra, dealing with the Revenue Act of 1928, follows the same line of reasoning. We do not find these decisions persuasive.

The revenue acts of 1918 to 1921, inclusive, contained provisions allowing deduction of a reasonable allowance for depletion of oil and gas wells, based on cost, including cost of development, not otherwise deducted. The Revenue Act of 1924 continued this allowance for depletion on the cost basis, with the limitation that the deduction should not exceed 50% of the net income from the property, computed without allowance for depletion. The Revenue Act of 1926 made a radical change as to the basis for computing an allowance for depletion. The act provided for a deduction for depletion, based on cost, in computing the gain or loss resulting from a sale or other disposition of the property, and also for an annual deduction for depletion, measured by 27½% of gross income, but not exceeding 50% of the net income, computed without allowance for depletion. These provisions have been continued [fol. 67] in all subsequent revenue acts, practically the same as in the 1932 Act, as above quoted.

Treasury Regulations promulgated under the 1926 Act were silent as to the method of computing depletion by the percentage method. Under the 1924 Act the Commissioner had ruled that net income meant net operating revenue and excluded development costs in computing it. For awhile this practice was continued under the 1926 Act but was changed on September 26, 1927, and the present practice was adopted. See G. C. M. 2315, VI-2 Cumulative Bulletin 21. Thereafter, beginning with Treasury Regulations 74, under the 1928 Act, regulations were adopted substantially the same as those adopted under the 1932 Act, above quoted.

The Commissioner contends that the rule of legislative approval is in his favor, relying upon U. S. vs. Dakota-Montana Oil Co., 288 U. S. 459 and other decisions. We agree with that contention. His decisions under the previous acts were certainly not approved by the enactment of the 1926 statute. Nor do we think the short time he applied the old rule under the 1926 Act estopped him from changing it, if convinced he was wrong. After the Commissioner had changed his ruling, the pertinent provisions of the 1926 Act were reenacted in the 1928 and subsequent revenue acts without substantial change. However, the de-

cision of the question presented does not depend upon the application of the rule.

The revenue laws adopted before the 1926 Act show conclusively that if costs of development were deducted as expense they could not thereafter be added to increase the basis for depletion. We find nothing in the subsequent statutes tending to show Congress intended to adopt a different principle when depletion is deducted annually and determined by the percentage method.

[fol. 68] The deduction of intangible costs of drilling and development from gross income reduces the net income upon which taxes are assessed. If there was no allowance for depletion the tax would be paid on that basis. The statute is plain and unambiguous. Necessarily, if development costs are excluded in computing net income, in those instances where 27½% of the gross income exceeds 50% of the net income, they enter into and add to the basis for depletion. The only reasonable construction of the statute is that net income, computed without allowance for depletion, means what is left after every allowable item, except depletion, is deducted from gross income.

The regulations are reasonable, fair to the taxpayer and conform to the intention of Congress. We consider that when a taxpayer elects to deduct intangible costs of drilling and development as expense that item must be treated the same as all other deductible items in computing net income. The Commissioner was right in including such deductions in determining net income for the purpose of applying the 50% limitation.

The petition is allowed, the judgment of the Board is reversed and the cause is remanded for further proceedings not inconsistent with this opinion.

[fol. 69] JUDGMENT

Extract from the Minutes of March 21st, 1939

No. 8800

COMMISSIONER OF INTERNAL REVENUE

versus

F. H. E. OIL COMPANY

This cause came on to be heard on the petition of the Commissioner of Internal Revenue for a review of a de-

cision of the United States Board of Tax Appeals, and was argued by counsel;

On consideration whereof, It is now here ordered, adjudged and decreed by this Court, that said petition be allowed; that the judgment of the said United States Board of Tax Appeals in this cause be, and the same is hereby, reversed; and that this cause be, and it is hereby, remanded to the said United States Board of Tax Appeals for further proceedings not inconsistent with the opinion of this Court.

[fol. 70] CLERK'S CERTIFICATE

UNITED STATES OF AMERICA:

UNITED STATES CIRCUIT COURT OF APPEALS, FIFTH CIRCUIT

I, Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals for the Fifth Circuit, do hereby certify that the pages numbered from 62 to 69 next preceding this certificate contain full, true and complete copies of all the pleadings, record entries and proceedings, including the opinion of the United States Circuit Court of Appeals for the Fifth Circuit, in a certain cause in said Court, numbered 8800, wherein the Commissioner of Internal Revenue is petitioner, and F. H. E. Oil Company is respondent, as full, true and complete as the originals of the same now remain in my office.

I further certify that the pages of the printed record numbered from 1 to 61 are identical with the printed record upon which said cause was heard and decided in the said Circuit Court of Appeals.

In testimony whereof, I hereunto subscribe my name and affix the seal of the said United States Circuit Court of Appeals, at my office in the City of New Orleans, Louisiana, in the Fifth Circuit, this 25th day of March, A. D. 1939.

Oakley F. Dodd, Clerk of the United States Circuit Court of Appeals, Fifth Circuit. (Seal United States Circuit Court of Appeals, Fifth Circuit.)

[fol. 71] SUPREME COURT OF THE UNITED STATES

ORDER ALLOWING CERTIORARI—Filed May 1, 1939

The petition herein for a writ of certiorari to the United States Circuit Court of Appeals for the Fifth Circuit is granted, and the case is assigned for argument immediately following Nos. 163, 164, and 165.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

Mr. Justice Reed took no part in the consideration and decision of this application.

Endorsed on cover: Enter Harry C. Weeks. File No. 43,323. U. S. Circuit Court of Appeals, Fifth Circuit. Term No. 838. F. H. E. Oil Company, Petitioner, vs. Commissioner of Internal Revenue. Petition for a writ of certiorari and exhibit thereto. Filed April 4, 1939. Term No. 838, O. T., 1938.